

Strothman & Company P S C

Certified Public Accountants & Advisors



Financial Statements

**Kentucky Higher Education
Assistance Authority**

June 30, 2006

Financial Statements

Kentucky Higher Education Assistance Authority

June 30, 2006

| | |
|--|----------|
| Independent Auditors' Report | 1 |
| Management's Discussion and Analysis (Unaudited) | 3 |
| Financial Statements | |
| Government-Wide Statement of Net Assets | 13 |
| Government-Wide Statement of Activities | 14 |
| Statement of Net Assets – Proprietary Funds | 15 |
| Statement of Revenues, Expenses and Changes in Net Assets – Proprietary Funds | 16 |
| Statement of Cash Flows – Proprietary Funds | 17 |
| Balance Sheet – Governmental Fund | 19 |
| Statement of Revenues, Expenditures and Changes in Fund Balance – Governmental Fund | 20 |
| Statement of Fiduciary Net Assets (Deficit) | 21 |
| Statement of Changes in Fiduciary Net Assets (Deficit) | 22 |
| Notes to Financial Statements | 23 |

Independent Auditors' Report



Board of Directors
Kentucky Higher Education Assistance Authority
Frankfort, Kentucky

We have audited the accompanying financial statements of the governmental activities, the business-type activities, each major fund and the aggregate remaining fund information of the Kentucky Higher Education Assistance Authority (the "Authority") as of and for the year ended June 30, 2006, which collectively comprise the Authority's basic financial statements as listed in the accompanying table of contents. These financial statements are the responsibility of the Authority's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of Kentucky Education Savings Plan Trust, which statements reflect total assets of \$78,455,684 as of June 30, 2006, and total additions to fiduciary net assets of \$17,351,393 for the year ended June 30, 2006. Those statements were audited by other auditors whose report thereon has been furnished to us, and our opinion expressed herein, insofar as it relates to the amounts included for Kentucky Education Savings Plan Trust, is solely based on the report of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund and the aggregate remaining fund information of the Authority as of June 30, 2006, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis on pages 3 through 12 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 26, 2006 on our consideration of the Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

STROTHMAN & COMPANY PSC

Louisville, Kentucky
September 26, 2006

Kentucky Higher Education Assistance Authority

June 30, 2006

Description of the Business

The Kentucky Higher Education Assistance Authority (the Authority) was established in 1966 as the Commonwealth of Kentucky's agency for improving higher education opportunities. The Authority guarantees eligible student loans, and through the Kentucky Educational Savings Plan Trust (the Trust), the Authority offers savings and investment opportunities for Kentuckians to save for higher education, and through the Kentucky Affordable Prepaid Tuition plan (the Plan), the Authority offers Kentuckians an opportunity to pay future tuition and related expenses at a reduced present value rate.

In November 1978, the Authority commenced guaranteeing student loans as the designated guarantee agency for the Commonwealth of Kentucky pursuant to the Federal Higher Education Act (the Act) of 1965, as amended. On July 1, 1996, the Authority was designated by U.S.D.E as the guarantee agency for the state of Alabama. As such, with regard to eligible student loans originated by the State of Alabama, the Authority is responsible for issuing loan insurance, providing assistance to lenders and lender servicers, paying lender claims and collecting defaulted loans on which claims have been paid.

The Higher Education Amendments of 1998 (the 1998 Amendments), enacted on October 7, 1998, with an effective date of October 1, 1998, changed the manner in which FFELP is administered. Under the 1998 Amendments, the Authority established a Federal Student Loan Reserve Fund (FSLRF) and an Agency Operating Fund (AOF).

The FSLRF assets and all earnings on those assets are the property of the Federal government. The funds in the newly established FSLRF are used to reimburse the lenders for defaulted student loan claims, pay the AOF for default aversion fees, and any Account Maintenance Fee (AMF) and Loan Processing and Issuance Fee (LPIF) due to/from the U.S.D.E when federal funds are unavailable. Funds used to pay loan claims are replenished from reimbursements from the federal government. The FSLRF also receives a rebate of default aversion fees paid if a default claim is paid.

The AOF holds and accounts for funds, controlled by the Authority, which are restricted for use on student aid and related activities. Sources of funds to the AOF include investment income, agency retention on collections of defaulted loans, default aversion fees, AMF (.10% of original Principal Outstanding), LPIF (.40% of loans guaranteed and disbursed), and loan and lender servicing fees. Expenditures from the AOF include personnel and professional expenses, administrative expenses, and rebates of default aversion fees paid if a default claim is paid.

In addition to the funds established by the 1998 amendments to the Act, the Authority administers ten major state sponsored grant and scholarship programs and provides higher education outreach activities. Funds established to administer these programs (Student Aid Fund) are maintained within the State Treasury. Sources of monies to the Student Aid Fund include general fund appropriations, federal awards, lottery net revenues, coal severance tax, tobacco settlement funds, and transfers from the AOF and the Kentucky Higher Education Student Loan Corporation (the Corporation). Uses of funds include state grant and scholarship awards and personnel and professional and other administrative expenses directly related to the administration of the student aid programs and outreach activities.

Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

The Authority is also charged with managing the Trust, an Internal Revenue Service Code 529 plan, which was created in 1988 by the General Assembly to assist people in saving for the cost of education after high school. The Trust is administered by the Authority's Board of Directors and is being managed by TIAA-CREF Tuition Financing, Inc. (TFI).

The Authority is also charged with managing the Commonwealth Postsecondary Education Prepaid Trust Fund, also known as Kentucky's Affordable Prepaid Tuition or KAPT (the Plan). The Plan was created by the 2000 General Assembly and oversight was transferred to the Authority in the 2003 budget bill, House Bill 269. Upon expiration of the 2003 budget bill, on July 1, 2004, the Plan was transferred back to a separate board of directors. In fiscal year 2005, management responsibility for the Plan was returned to the Authority. The Plan is an Internal Revenue Service Code 529 plan, which allows participants to purchase future tuition at reduced present value rates.

The FSLRF, the Agency Fund (used to account for loan proceeds handled by the Authority on behalf of lenders and schools), the Trust and the Plan are accounted for as Fiduciary Funds. The AOF and the internal service fund (an administrative fund held by the state treasury) are accounted for as Proprietary Funds. The Governmental Fund is comprised of assets maintained for grant and scholarship program benefits.

Overview of Financial Statements

This discussion and analysis is intended to serve as an introduction to the Authority's basic financial statements. The Authority's basic financial statements comprise three components: 1) government-wide financial statements, 2) fund financial statements; and 3) notes to financial statements. This report contains other supplementary information in addition to the basic financial statements.

The government-wide statement of net assets and statement of activities include the Governmental Funds and Proprietary Funds. The government-wide financial statements can be found on pages 13 and 14 of this report. The fund financial statements can be found on pages 15 through 20 of this report.

Fiduciary funds are used to account for resources held for the benefit of parties outside the Authority. Fiduciary funds are not reflected in the government-wide financial statements because the resources are not available to support the Authority's programs. The fiduciary fund statement of net assets and changes in fiduciary net assets can be found on pages 21 and 22 of this report.

The Corporation, the Plan and the Trust each publish separate financial statements and footnotes. To obtain a copy of the financial statements and footnotes, please contact the Authority at (502) 696-7421.

The following is a condensed summary of financial information for the years ended June 30, 2006 and 2005, respectively.

Condensed Financial Information - Governmental Fund and Proprietary Funds

Kentucky Higher Education Assistance Authority

| | Governmental Fund | | Proprietary Funds | |
|--|----------------------|-----------------------|----------------------|----------------------|
| | 2006 | 2005 | 2006 | 2005 |
| Net Asset Information | | | | |
| Capital assets | | | \$ 10,613,852 | \$ 11,603,159 |
| Other assets | \$ 17,257,192 | \$ 13,419,346 | 30,337,761 | 31,202,925 |
| Total Assets | 17,257,192 | 13,419,346 | 40,951,613 | 42,806,084 |
| Long-term liabilities | | | 6,990,000 | 7,370,000 |
| Other liabilities | 185,171 | 1,169,222 | 1,860,123 | 8,426,074 |
| Total Liabilities | 185,171 | 1,169,222 | 8,850,123 | 15,796,074 |
| Net assets invested in capital, net of debt | | | 3,472,601 | 4,130,622 |
| Restricted net assets | 17,072,021 | 12,250,124 | 28,628,889 | 22,879,388 |
| Total Net Assets | \$ 17,072,021 | \$ 12,250,124 | \$ 32,101,490 | \$ 27,010,010 |
| Activity Information | | | | |
| Interest and investment income | \$ 205,301 | \$ 198,593 | \$ 548,584 | \$ 491,509 |
| State General Fund revenue | 160,557,148 | 71,355,300 | | |
| Student Aid & Advancement Fund revenue | | 71,329,445 | | |
| Unclaimed Lottery Revenue | 11,311,000 | 9,758,300 | | |
| Federal funds revenue | 1,469,085 | 1,516,318 | | |
| Tobacco settlement revenue | 860,503 | 900,000 | | |
| Service fees | | | 1,766,945 | 1,108,436 |
| Debt recovery commission | | | 8,716,891 | 8,200,814 |
| Federal fees earned | | | 8,666,987 | 6,466,687 |
| Default aversion fee income | | | 1,659,605 | 1,550,869 |
| Other income | 2,449,517 | 726,887 | 303,722 | 408,960 |
| Total Revenues | 176,852,554 | 155,784,843 | 21,662,734 | 18,227,275 |
| Kentucky Tuition Grants | 28,225,907 | 26,470,479 | | |
| College Access Program Grants | 56,717,885 | 50,624,331 | | |
| Byrd Scholarship | 534,530 | 664,275 | | |
| Mary J Young | 495,427 | | | |
| Early Childhood Development | 968,916 | 984,723 | | |
| National Guard Tuition Awards | 3,042,347 | 2,681,518 | | |
| Kentucky Education Excellence Scholarships | 87,577,069 | 82,468,338 | | |
| Teacher Scholarships | 2,116,590 | 1,167,096 | | |
| Osteopathic Medicine Scholarships | 360,628 | 2,332,395 | | |
| Work study | 864,008 | 936,748 | | |
| Outreach and other activities | 1,138,021 | 773,411 | | |
| Guarantee operations | | | 5,034,366 | 5,478,206 |
| Default collection | | | 3,110,830 | 4,189,464 |
| Lender assistance | | | 2,643,711 | 2,929,374 |
| Other activities | | | 289,831 | 389,677 |
| Total Expenditures | 182,041,328 | 169,103,314 | 11,078,738 | 12,986,721 |
| Change in Net Assets Before Operating Transfers | (5,188,774) | (13,318,471) | 10,583,996 | 5,240,554 |
| Interfund transfer | 5,250,980 | 4,577,624 | (5,250,980) | (4,577,624) |
| Transfer to KAPT | | | (241,536) | (188,649) |
| Transfer to Federal Student Loan Reserve Fund | | | | (145,336) |
| Transfer From KHESLC | 4,759,691 | 7,151,055 | | |
| Change in Net Assets | \$ 4,821,897 | \$ (1,589,792) | \$ 5,091,480 | \$ 328,945 |

Condensed Financial Information - Fiduciary Funds

Kentucky Higher Education Assistance Authority

| | Federal Student Loan Reserve Fund | | Agency Fund | | Kentucky Affordable Prepaid Tuition | | Kentucky Education Savings Plan Trust | |
|---|--------------------------------------|-----------------------|----------------|----------------|--|-----------------------|--|----------------------|
| | 2005 | 2005 | 2006 | 2005 | 2006 | 2005 | 2006 | 2005 |
| Net Asset Information | | | | | | | | |
| Capital assets | | | | | | | | |
| Other assets | \$ 14,475,858 | \$ 17,986,421 | \$ 693,785 | \$ 595,449 | \$ 143,763,132 | \$ 135,382,731 | \$ 78,609,020 | \$ 65,527,551 |
| Total Assets | 14,475,858 | 17,986,421 | 693,785 | 595,449 | 143,763,132 | 135,382,731 | 78,609,020 | 65,527,551 |
| Total Liabilities | 13,242,816 | 7,250,484 | 693,785 | 595,449 | 164,072,370 | 141,977,631 | 153,336 | 157,436 |
| Net assets invested in capital, net of debt | | | | | - | 2,517 | | |
| Restricted net assets (deficit) | 1,233,042 | 10,735,937 | | | (20,309,238) | (6,597,417) | 78,455,684 | 65,370,115 |
| Total Net Assets | \$ 1,233,042 | \$ 10,735,937 | \$ - | \$ - | \$ (20,309,238) | \$ (6,594,900) | \$ 78,455,684 | \$ 65,370,115 |
| Changes in Fiduciary Net Asset Information | | | | | | | | |
| Federal reinsurance | \$ 64,027,230 | \$ 50,088,866 | | | | | | |
| Contributions | | | | | \$ 5,197,618 | \$ 32,075,577 | | |
| Subscriptions | | | | | | | \$ 12,380,079 | \$ 12,392,752 |
| Other income | 849,567 | 467,878 | | | 7,364,072 | 5,456,796 | 4,971,314 | 4,704,824 |
| Total Additions | 64,876,797 | 50,556,744 | | | 12,561,690 | 37,532,373 | 17,351,393 | 17,097,576 |
| Administrative expenses | | | | | 872,900 | 1,633,275 | 430,570 | 376,891 |
| Refunds | | | | | 1,421,005 | 990,777 | | |
| Trustee expense | | | | | 313,210 | 257,122 | | |
| Tuition benefits | | | | | 23,907,932 | 43,243,458 | | |
| Loan claims | 69,235,562 | 52,411,691 | | | | | | |
| Redemptions | | | | | | | 3,835,254 | 3,746,945 |
| Default aversion | 1,659,605 | 1,550,869 | | | | | | |
| Other expenses | 3,484,525 | 1,074,078 | | | 2,517 | 2,018 | | |
| Total Deductions | 74,379,692 | 55,036,638 | | | 26,517,564 | 46,126,650 | 4,265,824 | 4,123,836 |
| Change in net assets before operating transfer | (9,502,895) | (4,479,894) | | | (13,955,874) | (8,594,277) | 13,085,569 | 12,973,740 |
| Operating Transfers | | | | | | | | |
| Transfer from Agency Operating Fund | | 145,336 | | | 241,536 | 188,649 | | |
| Transfer from Unclaimed Property Fund | | | | | | 13,700,051 | | |
| Change in Net Assets After Operating Transfers | \$ (9,502,895) | \$ (4,334,558) | | | \$ (13,714,338) | \$ 5,294,423 | \$ 13,085,569 | \$ 12,973,740 |

Kentucky Higher Education Assistance Authority

June 30, 2006

Financial Analysis – Governmental and Proprietary Funds

This section of the Kentucky Higher Education Assistance Authority's (the Authority's) annual financial report presents a discussion and analysis of the Authority's government-wide performance for the fiscal year ended June 30, 2006. Please read it in conjunction with the Authority's financial statements and notes to the financial statements, which follow this section.

Financial Overview

- The Authority's proprietary total assets decreased approximately \$1.8 million, from \$42.8 million to \$41 million.
- The Authority's proprietary revenue for the fiscal year ended June 30, 2006, was \$21.6 million, which is an increase of \$3.4 million, a 19% increase over prior year.
- The Authority's service fee income for the fiscal year ended June 30, 2006 was \$1.7 million, which is a \$600,000 increase, 59% increase over prior year.
- The Authority provided approximately \$85.8 million in need-based grants and scholarships and \$91.4 million in other scholarships.
- The Authority's proprietary fund change in net assets after operating transfers for the fiscal year ended June 30, 2006, was \$5 million, a \$4.7 million increase from prior year.

Statement of Net Assets

Total government fund net assets increased \$4.8 million, due to the impact of the Authority being more conservative with the use of student aid funds and increasing the conversion loan value in fiscal year 2006. In fiscal year 2006, the Authority implemented a new student aid delivery system. Also, in fiscal year 2006 the Authority's Governmental Fund received a \$7.5 million transfer from the Corporation. It was later determined that the Corporation needed a rebate of \$2.7 million to address current obligations resulting in a net transfer of \$4.8 million. To address new procedures programmed into the student aid system and the need for available funds to transfer to the Corporation, the Authority managed its student aid funds more conservatively, thus increasing net assets by \$1.3 million. In fiscal year 2006, the Authority decreased the conversion loan valuation allowance by \$1.8 million (from \$5.4 to \$3.6 million), and decreased the portfolio by a net \$700,000 million (new awards net of payments and service credits), resulting in a net increase of \$1.1 million. Note that the Authority decreased the valuation allowance because of increased collection performance on the conversion loan portfolio by the Authority's loan collection area.

Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Total proprietary assets decreased \$1.8 million (4%), due primarily to a decrease in cash, cash equivalents and investments of \$5.1 million and a decrease in fixed assets of \$1 million, net of the increase in receivable from the FSLRF of \$3.9 million and increase in the postage and origination fees receivable from KHESLC of \$300,000. The decrease in cash and equivalents resulted mostly from the Authority paying KHESLC \$4.8 million for prior year shared service activities. The decrease in fixed assets resulted from current year depreciation. The increase in receivable from the FSLRF resulted from the Authority delaying transfers related to defaulted loan receipts, net of Account Maintenance Fee shortfall. Proprietary liabilities decreased \$6.9 million (44%), due primarily to the decrease in payable to KHESLC of \$4.8 million, decrease in accounts payable and accrued expenses of \$1.7 million and decrease in capital lease payable of \$400,000. The decrease in payable to KHESLC resulted from cash paid in fiscal year 2006. The decrease in payables and accrued expenses resulted from the timing of settlement payments to/from USDE, and the decrease in capital lease payable resulted from scheduled debt service payments in fiscal year 2006.

Statement of Revenues, Expenditures, and Changes in Net Assets

Government fund revenues increased 13.6%, due to increased funding from the Kentucky Lottery Corporation. In 1998, the Kentucky State Legislature created the KEES program and tied state lottery revenue to KEES and need-based scholarship and grant funding. In fiscal year 2005, the Authority received 90% of available lottery net revenue. In fiscal year 2006, the Authority received 100% of available lottery net revenue, an 11% increase over prior year. This increase was enhanced by the lottery enjoying additional revenues in fiscal year 2006, compared to the prior year. Also, in fiscal year 2006, the Authority reduced its allowance for uncollectible conversion loans by \$1.8 million, which was recorded as other income. The allowance was reduced because of significant improvements made by the Authority's collection area and implementation of House Bill 162, Senate Bill 228, which required the Authority to send certain conversion loans to the Commonwealth of Kentucky Revenue Cabinet for collection.

Governmental expenditures increased 7% (\$13 million), which is comprised of a relatively insignificant increase in indirect expenses (\$200,000) and a \$12.8 million increase in direct expenses. Direct benefits increased primarily due to the increase in KEES awards (because the program is in the final year of an 8-year phase-in process). The Kentucky Tuition Grant (KTG) and College Access Program (CAP) programs also noted increases in direct benefits (KTG increased 7 % and CAP increased 12%). The increases in CAP and KTG resulted from increased lottery funds received. The Teacher Scholarship program realized a \$900,000 increase in expenses from fiscal year 2005, due to increased collection activities resulting in increased service credits.

The National Guard Tuition awards increased \$400,000 due to increased focus on assisting Kentucky National Guard members with higher education opportunities. The Mary Jo Young Scholarship expenses increased \$366,000, since this was the first year the program was administered in the Student Aid Fund (in the prior year the program was administered in the Internal Service Fund).

Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

The Authority's proprietary fund experienced a 100% increase in changes in net assets before operating transfers, resulting from a 19% increase in revenue and a 15% decrease in expenditures. Revenues increased 59% (\$650,000) in the loan origination servicing operation due to increased loan origination fees and disbursement service fees the Authority charges to lenders. Debt recovery commission increased 6% (\$500,000) due to improvements made in the Authority's loan collection area made in the second half of fiscal year 2006. Federal fees increased 34% (\$2.2 million) due to Account Maintenance Fee payment requirements resulting from the 2006 Federal Budget Reconciliation Act.

The decrease in expenses resulted from a decrease in personnel costs, default aversion expense, and depreciation expense. Personnel and professional expense decreased 12% (\$1.1 million) due to the Authority moving certain costs to the Corporation. Default aversion expense decreased 100% (\$700,000) due to the Authority exhausting all remaining escrowed default aversion federal funds in fiscal year 2005. Depreciation expense decreased 28% (\$260,000) due to a new depreciation policy implemented in fiscal year 2005, which resulted in most of the Authority's fixed assets becoming fully depreciated during that fiscal year. Note that most fixed asset acquisitions have been processed through the Corporation for the past three years and accounted for via the shared serviced agreement. Accordingly, the Authority has acquired very few fixed assets in the past three years, and thus depreciation expense is minimal.

Financial Analysis – Fiduciary Funds

This section of the Kentucky Higher Education Assistance Authority's (the Authority's) annual financial report presents a discussion and analysis of the Authority's fiduciary fund performance for the fiscal year ended June 30, 2005. Please read it in conjunction with the Authority's financial statements and notes to the financial statements, which follow this section.

Financial Overview

- Claims expenses in the Federal Student Loan Reserve Fund (FSLRF) increased from \$52 million in fiscal year 2005 to \$69 million in fiscal year 2006, a 33% increase compared to prior year.
- Non-claim related expenses in the FSLRF increased from 2.6 million in fiscal year 2005 to 5.1 million in fiscal year 2006, a 96% increase over prior year.
- The Authority had an enrollment period for the Kentucky Affordable Prepaid Tuition plan (the Plan) in fiscal year 2005, resulting in \$32.6 million of new contracts (net present value). There was no enrollment period in fiscal year 2006, resulting in a decrease in contribution revenue of \$26.9 million.
- The Plan noted an increase of tuition benefits payable of \$23.9 million in fiscal year 2006, largely due to a 12% increase in tuition at the University of Kentucky in academic year 2006-2007.

Continued

Management's Discussion and Analysis (Unaudited)--Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

- Interest and investment income in the Plan increased from \$5.2 million to \$7.3 million, an increase of 40% compared to prior year.

Statement of Fiduciary Net Assets (Deficit)

The FSLRF assets decreased approximately 20% (\$3.5 million), while liabilities increased approximately 83% (\$5.9 million). The decrease in assets is attributed to the decrease in receivable from the U.S.D.E of \$3.5 million, resulting from the timing of settlement payments from the USDE. The increase in liabilities is comprised of the increase in reserve for loan loss of \$3.7 million, the increase in payable to the Agency Operating Fund (AOF) of \$3.9 million, net of the decrease in accounts payable resulting from the timing of settlement payments from the USDE. The Authority increased the reserve for loan loss 134% due to recent experience with claim volume and a higher than normal loss on reinsurance (due to lenders obtaining the exceptional performer designation). The increase in payable to AOF resulted from the Authority delaying certain payments from the FSLRF to cash flow claim payments to lenders.

The Agency Funds serves as a conduit for loan proceeds transacted between lenders and schools. The Authority typically maintains Agency funds for lenders and schools for less than three business days. At June 30, 2005, the Authority maintained \$595,449 on behalf of lenders. At June 30, 2006, the Authority maintained \$693,785 on behalf of lenders.

The Plan's total assets increased \$8.4 million, which resulted from an increase in investments of \$12.1 million, net of the decrease in contributions receivable and accrued income of \$3.7 million. Cash and investments increased because of contract receipts of \$10.5 million (including \$600,000 of contract income), net of matriculation of \$4.1 million and cancellations of \$1.4 million, interest and investment income of \$7.3 million and operating expenses and trustee fees of \$1.2 million and transfers and other income of \$1 million. The contributions receivable decreased because no new contracts were sold in fiscal year 2006 and participants paid and/or cancelled contracts totaling \$3.8 million, net of the allowance for cancellations.

The Plan liabilities increased \$22.1 million, almost entirely from the increase in tuition benefits payable. The \$22.1 million increase in tuition benefits payable resulted from current year changes to actuarial assumptions for tuition increases, administrative costs, and investment income expense; and the actual tuition increase experience at Kentucky institutions for the 2006-2007 academic year. The University of Kentucky tuition increase, on which the majority of Plan tuition payouts are based, increased 12% for the 2006-2007 academic year. In fiscal year 2005, the tuition increase assumptions were based on 7.5% increases annually through June 30, 2012, 7.25% annually through June 30, 2014, and 7.0% annually thereafter. To reflect higher than anticipated tuition increases, assumptions in 2006 were raised to 11% for the 2007-2008 academic year, 10% for the 2008-2009 academic year, and 7% for each year thereafter. Projected investment expense was changed as follows: In fiscal year 2005, projected investment expense was calculated on a sliding scale of costs related to total assets, 49 basis points on the first \$25 million, 28 basis points on the next \$25 million, and 21 basis points on assets in excess of \$50 million. In fiscal year 2006 projected investment expense was calculated based on 35 basis points on all invested assets. Projected administrative expenses remained unchanged at \$6.2 million.

Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

The Trust is an Internal Revenue Code 529 plan managed by the Authority and administered on behalf of the Authority by TFI. Trust assets are entirely comprised of cash and pooled investments. Total assets increased approximately \$13.1 million, due to new subscriptions received (\$12.4 million) and investment income (\$4.9 million), net of expenses and redemptions (\$4.2 million). Trust liabilities remained relatively constant during the fiscal year.

Changes in Fiduciary Net Assets

The FSLRF had a reduction in fiduciary net assets of approximately \$9.5 million for the year ended June 30, 2006, which was \$5 million worse than previous year. The reduction resulted from an increase in default claims and an increase in Account Maintenance Fee (AMF) shortfall. Loan claims expense increased approximately 32%, due primarily to increased claim volume from lenders with the exceptional performer designation. The federal reinsurance increased approximately 28% and has a direct correlation to loan claims expense (since the Authority files for federal reinsurance on all claims paid), the difference representing a loss on reinsurance incurred by the FSRF. Note that the Authority collects AMF based on original principal outstanding as of September 30, 2005. If federal funds in the Section 458 account are unable to meet the demand for AMF, the Authority may transfer the shortfall amount from the FSLRF to the AOF. In fiscal year 2005, the Authority expensed \$2.4 million more in AMF shortfall than the amount transferred in fiscal year 2005. The increase in AMF shortfall expense resulted from the 2006 Budget Reconciliation Act, which required the Authority to expense additional AMF shortfall prior to June 30, 2006. Accordingly, the Authority expensed two years of AMF shortfall in fiscal year 2006; the amount normally expensed in October 2005, and the amount expensed in June 2006 as required by the USDE.

Investment income remained relatively consistent with prior year (\$32,000 increase). Other income increased \$350,000 due to increased collection results of rehabilitated loans. Default aversion expense remained relatively consistent with prior year (\$100,000 increase).

The Plan recognized an increase in net deficit of \$13.7 million for fiscal year 2006 compared to a \$5.3 million decrease in net deficit for the prior year. Note that the plan realized an \$8.6 million increase in net deficit in prior year, prior to accounting for a \$13.7 million transfer from the unclaimed property fund. Accordingly, the increase in net deficit in fiscal year 2006, resulting from operations, represents an increase of \$5.4 million over prior year.

The Plan held an enrollment period in fiscal year 2005 and received \$32 million in contract income. For the first time in its history, the Plan included a 7.5% actuarial premium in the cost of the new contracts sold during the fiscal year 2005 enrollment period, resulting in additional contract revenue of \$2.4 million in fiscal year 2005. The Plan also recognized \$5.2 million of investment income in fiscal year 2005.

In fiscal year 2006, the plan did not hold an enrollment period and contract income was comprised entirely of interest income on existing contracts and net reduction in allowance for contract cancellations, resulting in a \$26.9 million decrease from prior year. Investment income increased \$2.1 million due primarily to the overall increase in investments, from \$96 million in 2005 to \$112 million in 2006 (a 17% increase), and better investment performance in fiscal year 2006 over 2005.

Continued

Management's Discussion and Analysis (Unaudited)--Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Fee revenue decreased \$180,000 from prior year due to the age of existing contracts. The Plan recognized other revenue of \$13,000, which is consistent with prior year.

Administrative expenses decreased approximately \$700,000, from \$1.6 million to \$900,000. Administrative expenses decreased because the Plan incurred advertising costs in fiscal year 2005 in connection with the enrollment period and incurred almost no advertising costs in fiscal year 2006.

Due to the addition of the 1,860 contracts sold during the enrollment period in fiscal year 2005, recent volume of matriculated accounts (\$4.1 million) and changes in actuarial assumptions made as discussed above, the increase in tuition benefits expense was \$19.2 million less than prior year. Trustee expense and refunds remained relatively consistent with prior year.

The Plan recorded a transfer from the Unclaimed Property Fund of \$13.7 million in fiscal year 2005. In accordance with KRS 393.015, the board of directors voted to transfer the funds in December 2005 to eliminate the Plan's actuarial deficit as of June 30, 2004. There was no such transfer in fiscal year 2006. The Plan maintains one employee for operational functions. In fiscal year 2006, the Authority provided management, accounting, information technology support, legal services and office space to the Plan at no cost. The Authority allocated certain expenses to the Plan, which were recorded as a permanent transfer. Accordingly, the Plan recorded a transfer from the Authority in fiscal year 2006 of \$241,000, an increase of \$53,000 over prior year. The increase in transfers from the Authority resulted from overall increases in expenses at the Authority and increases in accounting and legal activities provided by the Authority to the Plan.

The Trust operations remained relatively consistent with prior year, noting a \$13 million increase in net assets in fiscal year 2006, compared to a \$12.9 million increase in the prior year. Contributions remained consistent (decreasing \$12,000) and investment income increased \$270,000, due primarily to the increase in total invested assets (\$78.6 million in fiscal year 2006 compared to \$65 million in fiscal year 2005). Redemptions and other expenses increased \$140,000 over prior year.

Government-Wide Statement of Net Assets

Kentucky Higher Education Assistance Authority

June 30, 2006

| ASSETS | Governmental Activities | Business-Type Activities | Total |
|---|------------------------------------|-------------------------------------|----------------------|
| Current: | | | |
| Cash and cash equivalents | \$ 2,590,833 | \$ 5,270,633 | \$ 7,861,466 |
| Due from KHESLC | | 265,386 | 265,386 |
| Receivable from Federal Student Loan Reserve Fund | | 4,996,235 | 4,996,235 |
| Accounts receivable | 2,411,803 | 1,332,197 | 3,744,000 |
| Accrued interest income | | 83,546 | 83,546 |
| Default aversion fees receivable | | 746,395 | 746,395 |
| Investments | | 582,936 | 582,936 |
| Teacher and Osteopathic Medicine scholarship loans | 450,000 | | 450,000 |
| Total Current Assets | 5,452,636 | 13,277,328 | 18,729,964 |
| Noncurrent: | | | |
| Restricted cash and cash equivalents | | 7,341,900 | 7,341,900 |
| Investments | | 9,521,684 | 9,521,684 |
| Teacher and Osteopathic Medicine scholarship loans, net | 3,454,781 | | 3,454,781 |
| Teacher and Osteopathic Medicine scholarship advances | 8,349,775 | | 8,349,775 |
| Property and equipment, net | | 10,613,852 | 10,613,852 |
| Deferred bond issuance costs, net | | 196,849 | 196,849 |
| Total Noncurrent Assets | 11,804,556 | 27,674,285 | 39,478,841 |
| Total Assets | 17,257,192 | 40,951,613 | 58,208,805 |
| LIABILITIES | | | |
| Current: | | | |
| Accounts payable and accrued expenses | 185,171 | 1,420,847 | 1,606,018 |
| Accrued interest expense | | 59,276 | 59,276 |
| Capital lease payable | | 380,000 | 380,000 |
| Total Current Liabilities | 185,171 | 1,860,123 | 2,045,294 |
| Noncurrent: | | | |
| Capital lease payable | | 6,990,000 | 6,990,000 |
| Total Noncurrent Liabilities | | 6,990,000 | 6,990,000 |
| Total Liabilities | 185,171 | 8,850,123 | 9,035,294 |
| NET ASSETS | | | |
| Invested in capital assets, net of expended debt proceeds | | 3,472,601 | 3,472,601 |
| Restricted, other | | 7,310,000 | 7,310,000 |
| Restricted for program benefits | 17,072,021 | | 17,072,021 |
| Restricted for student aid and related activities | | 21,318,889 | 21,318,889 |
| Total Net Assets | \$ 17,072,021 | \$ 32,101,490 | \$ 49,173,511 |

See Notes to Financial Statements

Government-Wide Statement of Activities

Kentucky Higher Education Assistance Authority

For the Year Ended June 30, 2006

| | | | Program Revenue | | Net (Expenses) Revenues and Changes in Net Assets | | |
|--|-----------------------|---------------------|----------------------|------------------------------------|---|--------------------------|----------------------|
| | Direct Expenses | Indirect Expenses | Charges for Services | Operating Grants and Contributions | Governmental Activities | Business-Type Activities | Total |
| Functions/Programs | | | | | | | |
| Governmental Activities | | | | | | | |
| Kentucky Tuition Grants | \$ 27,400,616 | \$ 825,291 | | \$ 28,239,376 | \$ 13,469 | | \$ 13,469 |
| College Access Program Grants | 55,858,660 | 859,225 | | 56,450,489 | (267,396) | | (267,396) |
| Robert S. Byrd Honors Scholarships | 491,866 | 42,664 | | 491,866 | (42,664) | | (42,664) |
| Mary Jo Young Scholarships | 366,639 | 128,788 | | - | (495,427) | | (495,427) |
| Early Childhood Development | 884,044 | 84,872 | | 985,215 | 16,299 | | 16,299 |
| National Guard Tuition Awards | 2,995,079 | 47,268 | | 19,237 | (3,023,110) | | (3,023,110) |
| Kentucky Education Excellence Scholarships | 86,460,765 | 1,116,304 | | 86,510,945 | (1,066,124) | | (1,066,124) |
| Teacher Scholarships | 1,740,295 | 376,295 | | 1,701,075 | (415,515) | | (415,515) |
| Osteopathic Medicine Scholarships | 162,437 | 198,191 | | 2,454,326 | 2,093,698 | | 2,093,698 |
| Work Study | 815,648 | 48,360 | | 25 | (863,983) | | (863,983) |
| Outreach and other activities | | 1,138,021 | | | (1,138,021) | | (1,138,021) |
| Total Governmental Activities | 177,176,049 | 4,865,279 | | 176,852,554 | (5,188,774) | | (5,188,774) |
| Business-Type Activities | | | | | | | |
| Loan guarantee operations | 5,034,366 | | \$ 10,857,588 | | | \$ 5,823,222 | 5,823,222 |
| Default collections | 3,110,830 | | 8,748,370 | | | 5,637,540 | 5,637,540 |
| Lender assistance | 2,643,711 | | 1,766,945 | | | (876,766) | (876,766) |
| Other activities | 289,831 | | 289,831 | | | | |
| Total Business-Type Activities | 11,078,738 | | 21,662,734 | | | 10,583,996 | 10,583,996 |
| Total | \$ 188,254,787 | \$ 4,865,279 | \$ 21,662,734 | \$ 176,852,554 | (5,188,774) | 10,583,996 | 5,395,222 |
| Transfers: | | | | | | | |
| Interfund transfer | | | | | 5,250,980 | (5,250,980) | |
| Transfer to KAPT | | | | | | (241,536) | (241,536) |
| Transfer from KHESLC | | | | | 4,759,691 | | 4,759,691 |
| Total Transfers | | | | | 10,010,671 | (5,492,516) | 4,518,155 |
| Change in Net Assets | | | | | 4,821,897 | 5,091,480 | 9,913,377 |
| Net Assets, Beginning of Year | | | | | 12,250,124 | 27,010,010 | 39,260,134 |
| Net Assets, End of Year | | | | | \$ 17,072,021 | \$ 32,101,490 | \$ 49,173,511 |

See Notes to Financial Statements

Statement of Net Assets - Proprietary Funds

Kentucky Higher Education Assistance Authority

For the Year Ended June 30, 2006

| ASSETS | Internal Service Fund | Agency Operating Fund | Total Proprietary Funds |
|---|--------------------------------------|--------------------------------------|--|
| Current: | | | |
| Cash and cash equivalents | \$ 1,839,347 | \$ 3,431,286 | \$ 5,270,633 |
| Receivable from Federal Student Loan Reserve Fund | | 4,996,235 | 4,996,235 |
| Due from the KHESLC | | 265,386 | 265,386 |
| Accounts receivable | 4,203 | 1,327,994 | 1,332,197 |
| Accrued interest income | | 83,546 | 83,546 |
| Default aversion fees receivable | | 746,395 | 746,395 |
| Investments | | 582,936 | 582,936 |
| Total Current Assets | 1,843,550 | 11,433,778 | 13,277,328 |
| Noncurrent: | | | |
| Restricted cash and cash equivalents | 31,900 | 7,310,000 | 7,341,900 |
| Investments | | 9,521,684 | 9,521,684 |
| Internal receivable (payable) for capital projects | (31,900) | 31,900 | |
| Property and equipment, net | | 10,613,852 | 10,613,852 |
| Deferred bond issuances costs, net | | 196,849 | 196,849 |
| Total Noncurrent Assets | | 27,674,285 | 27,674,285 |
| Total Assets | 1,843,550 | 39,108,063 | 40,951,613 |
| LIABILITIES | | | |
| Current: | | | |
| Accounts payable and accrued expenses | 1,403,995 | 16,852 | 1,420,847 |
| Interfund payable (receivable) | 439,555 | (439,555) | |
| Accrued interest expense | | 59,276 | 59,276 |
| Capital lease payable | | 380,000 | 380,000 |
| Total Current Liabilities | 1,843,550 | 16,573 | 1,860,123 |
| Noncurrent: | | | |
| Capital lease payable | | 6,990,000 | 6,990,000 |
| Total Noncurrent Liabilities | | 6,990,000 | 6,990,000 |
| Total Liabilities | 1,843,550 | 7,006,573 | 8,850,123 |
| NET ASSETS | | | |
| Invested in capital assets, net of expended debt proceeds | | 3,472,601 | 3,472,601 |
| Restricted, other | | 7,310,000 | 7,310,000 |
| Restricted for student aid and related activities | | 21,318,889 | 21,318,889 |
| Total Net Assets | \$ - | \$ 32,101,490 | \$ 32,101,490 |

Statement of Revenues, Expenses and Changes
in Net Assets - Proprietary Funds

Kentucky Higher Education Assistance Authority

For the Year Ended June 30, 2006

| | Internal Service Fund | Agency Operating Fund | Total Proprietary Funds |
|---|--------------------------------------|--------------------------------------|--|
| Operating Revenues: | | | |
| Service fees | | \$ 1,766,945 | \$ 1,766,945 |
| Debt recovery commission | | 8,716,891 | 8,716,891 |
| Federal fees earned | | 8,666,987 | 8,666,987 |
| Default aversion fee income | | 1,659,605 | 1,659,605 |
| Interest and investment income | | 548,584 | 548,584 |
| Other income | \$ 289,831 | 13,891 | 303,722 |
| Total Operating Revenues | 289,831 | 21,372,903 | 21,662,734 |
| Operating Expenses: | | | |
| Personnel and professional services | 156,676 | 7,638,778 | 7,795,454 |
| Other administrative expenses | 114,897 | 1,733,375 | 1,848,272 |
| Depreciation and amortization | 13,317 | 668,825 | 682,142 |
| Amortization of bond issuance costs | | 33,325 | 33,325 |
| Interest expense | 4,941 | 245,208 | 250,149 |
| Other expenses | | 469,396 | 469,396 |
| Total Operating Expenses | 289,831 | 10,788,907 | 11,078,738 |
| Operating Income | | 10,583,996 | 10,583,996 |
| Transfers In (Out) | | | |
| Interfund transfer | | (5,250,980) | (5,250,980) |
| Transfer to KAPT | | (241,536) | (241,536) |
| Total Transfers | | (5,492,516) | (5,492,516) |
| Increase in Net Assets After Transfers | | 5,091,480 | 5,091,480 |
| Net Assets, Beginning of Year | | 27,010,010 | 27,010,010 |
| Net Assets, End of Year | \$ - | \$ 32,101,490 | \$ 32,101,490 |

See Notes to Financial Statements

Statement of Cash Flows - Proprietary Funds

Kentucky Higher Education Assistance Authority

For the Year Ended June 30, 2006

| | Internal Service Fund | Agency Operating Fund | Total Proprietary Funds |
|--|--------------------------------------|--------------------------------------|--|
| Cash Flows from Operating Activities: | | | |
| Service fees | \$ 289,831 | \$ 1,099,472 | \$ 1,389,303 |
| Debt recovery commission | | 8,716,891 | 8,716,891 |
| Federal fees | | 8,666,987 | 8,666,987 |
| Default aversion fees | | 1,308,958 | 1,308,958 |
| Payroll costs | (156,676) | (7,638,778) | (7,795,454) |
| Other, net | (5,412,125) | (3,062,809) | (8,474,934) |
| Net Cash Provided By (Used In) Operating Activities | (5,278,970) | 9,090,721 | 3,811,751 |
| Cash Paid from Noncapital Financing Activities: | | | |
| Interfund transfers, net | | (241,536) | (241,536) |
| Increase in Federal Student Loan Reserve receivable | | (3,906,013) | (3,906,013) |
| Cash requirements | | (5,250,980) | (5,250,980) |
| Net Cash Used In Noncapital Financing Activities | | (9,398,529) | (9,398,529) |
| Cash Flows From Capital and Related Financing Activities | | | |
| Interfund transfers, net | (108,489) | 108,489 | |
| Capital expenditures | | (146,839) | (146,839) |
| Bond principle payments | | (365,000) | (365,000) |
| Interest paid on bonds | | (248,142) | (248,142) |
| Net Cash Used In Capital and Related Financing Activities | (108,489) | (651,492) | (759,981) |
| Cash Flows From Investing Activities: | | | |
| Purchases of investments | | (35,005,856) | (35,005,856) |
| Proceeds from sales/maturities of investments | | 37,763,374 | 37,763,374 |
| Investment income | | 782,587 | 782,587 |
| Net Cash Provided By Investing Activities | | 3,540,105 | 3,540,105 |
| Net Increases (Decrease) in Cash and Cash Equivalents | (5,387,459) | 2,580,805 | (2,806,654) |
| Cash and Cash Equivalents Beginning of Year | 7,258,706 | 8,160,481 | 15,419,187 |
| Cash and Cash Equivalents End of Year | <u>\$ 1,871,247</u> | <u>\$ 10,741,286</u> | <u>\$ 12,612,533</u> |

Continued

Statement of Cash Flows - Proprietary Funds--Continued

Kentucky Higher Education Assistance Authority

For the Year Ended June 30, 2006

| | Internal Service Fund | Agency Operating Fund | Total Proprietary Funds |
|--|--------------------------------------|--------------------------------------|--|
| Reconciliation of Operating Income to Net Cash Provided By (Used In) Operating Activities | | | |
| Operating income | | \$ 10,583,996 | \$ 10,583,996 |
| Adjustments to reconcile operating income to net cash provided by (used in) operating activities: | | | |
| Investment income | | (548,584) | (548,584) |
| Depreciation and amortization | | 1,169,470 | 1,169,470 |
| Interest expense | | 248,142 | 248,142 |
| (Increases) decreases in assets: | | | |
| Receivables | \$ 236,237 | (667,473) | (431,236) |
| Default aversion fee receivable | | (350,647) | (350,647) |
| Accrued interest income | | (13,053) | (13,053) |
| Increases (decreases) in liabilities: | | | |
| Accounts payable and accrued expenses | (528,498) | (1,223,430) | (1,751,928) |
| Interfund payable (receivable) | (4,986,709) | 4,986,709 | |
| Due to/from KHESLC | | (5,091,475) | (5,091,475) |
| Accrued interest | | (2,934) | (2,934) |
| Net Cash Provided By (Used In) Operating Activities | \$ (5,278,970) | \$ 9,090,721 | \$ 3,811,751 |

See Notes to Financial Statements

Balance Sheet - Governmental Fund

Kentucky Higher Education Assistance Authority

June 30, 2006

| | Governmental Fund Student Aid |
|---|--|
| ASSETS | |
| Current Assets: | |
| Cash and cash equivalents | \$ 2,590,833 |
| Accounts receivable | 2,411,803 |
| Teacher and Osteopathic Medicine scholarship loans | 450,000 |
| Total Current Assets | 5,452,636 |
| Noncurrent Assets: | |
| Teacher and Osteopathic Medicine scholarship loans, net of allowance of \$3,600,000 | 3,454,781 |
| Teacher and Osteopathic Medicine scholarship advances | 8,349,775 |
| Total Noncurrent Assets | 11,804,556 |
| Total Assets | \$ 17,257,192 |
| LIABILITIES | |
| Current: | |
| Accounts payable | \$ 185,171 |
| Total Liabilities | 185,171 |
| FUND BALANCE | |
| Fund Balance - Restricted for program benefits | 17,072,021 |
| Total Liabilities and Fund Balance | \$ 17,257,192 |

See Notes to Financial Statements

Statement of Revenues, Expenditures and Changes
in Fund Balance - Governmental Fund

Kentucky Higher Education Assistance Authority

For the Year Ended June 30, 2006

| | Governmental Fund Student Aid |
|--|--|
| Revenues: | |
| Interest and investment income | \$ 205,301 |
| Tobacco settlement revenue | 860,503 |
| State general fund revenue | 160,557,148 |
| Unclaimed lottery revenue | 11,311,000 |
| Federal funds revenue | 1,469,085 |
| Other income | 2,449,517 |
| Total Revenues | 176,852,554 |
| Expenditures: | |
| Kentucky Tuition Grants | 28,225,907 |
| College Access Program Grants | 56,717,885 |
| Robert S. Byrd Honors Scholarships | 534,530 |
| Mary Jo Young Scholarships | 495,427 |
| Early Childhood Development Scholarships | 968,916 |
| National Guard Tuition Awards | 3,042,347 |
| Kentucky Education Excellence Scholarships | 87,577,069 |
| Teacher Scholarships | 2,116,590 |
| Osteopathic Medicine Scholarships | 360,628 |
| Work Study | 864,008 |
| Outreach and other activities | 1,138,021 |
| Total Expenditures | 182,041,328 |
| Excess of Expenditures Over Revenues | (5,188,774) |
| Other Financing Sources and Uses, Including Transfers | |
| Interfund transfers | 5,250,980 |
| Transfer from KHESLC | 4,759,691 |
| Total Other Financing Sources and Uses, Including Transfers | 10,010,671 |
| Net Change in Fund Balance | 4,821,897 |
| Fund Balance, Beginning of Year | 12,250,124 |
| Fund Balance, End of Year | \$ 17,072,021 |

See Notes to Financial Statements

Statement of Fiduciary Net Assets (Deficit)

Kentucky Higher Education Assistance Authority

June 30, 2006

| ASSETS | Federal Student Loan Reserve Fund | Agency Fund | Kentucky's Affordable Prepaid Tuition | Kentucky's Educational Savings Plan Trust |
|--------------------------------------|---|----------------|--|--|
| Current: | | | | |
| Cash and cash equivalents | \$ 5,624,749 | \$ 693,785 | \$ 6,008,458 | \$ 928,991 |
| Contributions receivable | | | 5,635,989 | |
| Fees receivable | | | 199,549 | |
| Investments | | | | 77,620,957 |
| Receivables | 6,302,045 | | | 59,072 |
| Accrued interest income | 34,575 | | 512,590 | |
| Other current assets | 212,199 | | | |
| Total Current Assets | <u>12,173,568</u> | <u>693,785</u> | <u>12,356,586</u> | <u>78,609,020</u> |
| Noncurrent: | | | | |
| Investments | | | 112,542,778 | |
| Contributions receivable | | | 18,863,768 | |
| Restricted cash and cash equivalents | <u>2,302,290</u> | | | |
| Total Noncurrent Assets | <u>2,302,290</u> | | <u>131,406,546</u> | |
| Total Assets | <u>14,475,858</u> | <u>693,785</u> | <u>143,763,132</u> | <u>78,609,020</u> |
| LIABILITIES | | | | |
| Current: | | | | |
| Accounts payable | 1,050,186 | | 14,947 | 121,586 |
| Accrued expenses | 6,450,000 | | 28 | 31,750 |
| Origination distribution payable | | 693,785 | | |
| Payable to Agency Operating Fund | 4,996,235 | | | |
| Default Aversion fees payable | <u>746,395</u> | | | |
| Total Current Liabilities | <u>13,242,816</u> | <u>693,785</u> | <u>14,975</u> | <u>153,336</u> |
| Noncurrent: | | | | |
| Tuition benefits payable | | | 164,057,395 | |
| Total Liabilities | <u>13,242,816</u> | <u>693,785</u> | <u>164,072,370</u> | <u>153,336</u> |
| NET ASSETS | | | | |
| Restricted for program benefits | | | | 78,455,684 |
| Restricted for USDE recall | 2,302,290 | | | |
| Other | <u>(1,069,248)</u> | | <u>(20,309,238)</u> | |
| Total Net Assets (Deficit) | <u>\$ 1,233,042</u> | <u>\$ -</u> | <u>\$ (20,309,238)</u> | <u>\$ 78,455,684</u> |

See Notes to Financial Statements

Statement of Changes in Fiduciary Net Assets (Deficit)

Kentucky Higher Education Assistance Authority

For the Year Ended June 30, 2006

| | Federal Student Loan Reserve Fund | Kentucky's Affordable Prepaid Tuition | Kentucky's Educational Savings Plan Trust |
|---|--|--|--|
| Additions: | | | |
| Federal reinsurance | \$ 64,027,230 | | |
| Fee revenue | | \$ 17,262 | |
| Contract income, net | | 5,197,618 | |
| Subscriptions | | | \$ 12,380,079 |
| Investment Revenues: | | | |
| Net unrealized gain (loss) on investments | | 16,436 | (589,581) |
| Interest and investment Income | 283,129 | 7,317,576 | 5,560,895 |
| Other income | 566,438 | 12,798 | |
| Total Investment Revenues | 849,567 | 7,346,810 | 4,971,314 |
| Total Additions | 64,876,797 | 12,561,690 | 17,351,393 |
| Deductions: | | | |
| Program benefits: | | | |
| Loan claims | 69,235,562 | | |
| Default aversion fee expense | 1,659,605 | | |
| Redemptions | | | 3,835,254 |
| Administrative expenses | | 88,166 | 430,570 |
| Personnel and professional expenses | | 626,110 | |
| Other administrative expenses | | 158,624 | |
| Refunds | | 1,421,005 | |
| Trustee fee expense | | 313,210 | |
| Tuition benefits expense - payable | | 19,800,953 | |
| Tuition benefits expense - paid | | 4,106,979 | |
| Other expenses | 3,484,525 | 2,517 | |
| Total Deductions | 74,379,692 | 26,517,564 | 4,265,824 |
| Change in Net Assets Before Transfers | (9,502,895) | (13,955,874) | 13,085,569 |
| Transfer from Internal Service Fund | | 241,536 | |
| Change in Net Assets | (9,502,895) | (13,714,338) | 13,085,569 |
| Net Assets (Deficit) Beginning of Year | 10,735,937 | (6,594,900) | 65,370,115 |
| Net Assets (Deficit) End of Year | \$ 1,233,042 | \$ (20,309,238) | \$ 78,455,684 |

See Notes to Financial Statements

Notes to Financial Statements

Kentucky Higher Education Assistance Authority

June 30, 2006

Note A--Description of Business

The financial statements of the Kentucky Higher Education Assistance Authority include the following entities:

- The Kentucky Higher Education Assistance Authority (the "Authority")
- Kentucky's Affordable Prepaid Tuition Plan (the "Plan" or "KAPT")
- The Kentucky Education Savings Plan Trust (the "Trust")

The Authority was established in 1966 as the Commonwealth of Kentucky's (the "Commonwealth") agency for improving higher education opportunities. The Authority guarantees eligible student loans through the Trust, offers savings and investment opportunities for Kentuckians to save for higher education, and through KAPT, offers Kentuckians an opportunity to pay future tuition and related expenses at a reduced present value rate.

The Authority is closely related to the Kentucky Higher Education Student Loan Corporation (the "Corporation" or "KHESLC"). The Authority and the Corporation maintain separate but identical Boards of Directors. In accordance with Kentucky Revised Statutes 164.746 and 164A.050, the Authority and the Corporation each maintain a board comprised of the same ten members appointed by the Governor and the same five ex officio voting members. In addition, the Authority and the Corporation share certain key management personnel and services (see Note K for additional information).

In 2003, management of the Authority and the Corporation determined that the Corporation should be considered a component unit of the Authority. This was based on an analysis of the board structure which determined that the Authority's board, in effect, controlled the Corporation. Recently, a new analysis of the board structure determined that, even though the boards for the Authority and the Corporation were identical, neither organization has control over the other. As such, the Corporation will no longer be reported as a component unit of the Authority.

The Authority--The Authority guarantees loans to qualified students and parents of qualified students made by approved lenders in Kentucky and Alabama. Commencing in 1969, retroactive to 1965, the federal government agreed to insure 80% of such guaranteed student loans under the Guaranteed Student Loan Program, now known as the Federal Family Education Loan Program ("FFELP"). The FFELP, under which the Authority operates, was established by Congress and is administered by the United States Department of Education ("USDE") as a means of making loans available to students attending colleges, universities, and vocational institutions. The FFELP provides for the Authority to guarantee the repayment of principal and accrued interest to lenders for each eligible student loan. The Authority is responsible for processing loans submitted for guarantee, issuing loan guarantees, providing collection assistance to lenders for delinquent loans, paying lender claims for loans in default, and collecting loans on which default claims have been paid. The Authority also educates schools and lenders of FFELP requirements and regulatory changes, and encourages lender participation. Effective January 10, 1977, the Authority entered into a supplemental guaranty agreement with the federal government, which provided up to 100% reimbursement, depending upon default experience as specified in the agreement. Subsequently, federal reinsurance on guaranteed loans made from October 1, 1992 to September 30, 1998 was reduced to a maximum of 98% and

Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note A--Description of Business--Continued

federal reinsurance on guaranteed loans made on or after October 1, 1998 was reduced to a maximum of 95% (see Note E).

The Higher Education Amendments of 1998 (the "1998 Amendments") that were enacted on October 7, 1998, with an effective date of October 1, 1998, changed the manner in which FFELP is administered. Under the 1998 Amendments, the Authority established a Federal Student Loan Reserve Fund ("FSLRF") and an Agency Operating Fund ("AOF") as required to account for FFELP activities. The FSLRF assets and all earnings on those assets (except investment income on the 1998 Balance Budget Act set-aside funds) are the property of the Federal government. The reserves of the Authority were required to be deposited in the new Federal Fund no later than 60 days after enactment. The result of this federal legislation was that the Authority's fund equity of approximately \$40.6 million was transferred to the newly established FSLRF and the Authority's AOF commenced activities with a zero fund equity. The funds in the newly established FSLRF were used to pay the reimbursements to the lenders for defaulted student loan claims and pay the AOF for default aversion fees. Funds used to pay loan claims are replenished from reimbursements from the federal government.

Other sources of revenues of the FSLRF include the Federal compliment on collections of defaulted loans and investment income. All of the other sources and uses of funds not related to the FSLRF are recorded in the AOF. The AOF assets and earnings on those assets are the property of the Authority and may be used generally for all guaranty agency and other student financial aid related activities.

Sources of funds to the AOF includes investment income, agency retention on collections of defaulted loans, default aversion fees, account maintenance fees (.10% of original principle balance outstanding as of September 30), and loan processing and insurance fees (.40% of loans guaranteed and disbursed during the federal fiscal year).

Expenditures from the AOF include personnel, professional and other administrative expenses directly related to the loan program operations, and commission expense paid to a related party. Both the FSLRF and AOF are subject to federal oversight.

The Trust--In addition to operations related to the FFELP program, the Authority administers the Kentucky Education Savings Plan Trust and ten state grant and scholarship programs.

The Trust was formed on July 15, 1988 by Kentucky law, to help people save for the costs of education after high school. The Trust is administered by its Board of Directors, which is the same as the Authority's Board. The Authority has contracted with TIAA-CREF Tuition Financing, Inc. ("TIAA"), for management services over the Trust's operations. The Trust is operated in a manner such that it is exempt from registration as an investment company under the Investment Company Act of 1940.

An individual participating in the Trust establishes an account in the name of a beneficiary. Contributions can be made among three investment options: the Managed Allocation Option, the 100% Equity Option, and the Guaranteed Option.

Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note A--Description of Business--Continued

Contributions in the Managed Allocation Option are allocated among six age bands, based on the age of the beneficiary. Each age band invests in varying percentages in the Institutional Class of the International Equity, Growth Equity, Growth & Income, Inflation-Linked Bond, Equity Index, Small-Cap Blend Index, Bond, Large-Cap Value Index, Real Estate Securities, and Money Market Funds of the TIAA-CREF Institutional Mutual Funds. The 100% Equity Option invests in varying percentages in the Institutional Class of the International Equity and Growth & Income Funds of the TIAA-CREF Institutional Mutual Funds. All allocation percentages are determined by the Board and are subject to change. The assets of the Guaranteed Option are allocated to a funding agreement issued by TIAA-CREF Life Insurance Company, a subsidiary of TIAA, which offers a guarantee of principal and a minimum rate of return to the Trust.

The Plan--The Authority also administers the Commonwealth Postsecondary Education Prepaid Trust Fund, also known as Kentucky's Affordable Prepaid Tuition, which was created by the 2000 Kentucky General Assembly and is governed under Kentucky Revised Statutes 164A.700-709.

Effective July 1, 2003, responsibility for the governance and administration of the Plan was temporarily transferred to the Authority. In connection with the transfer of responsibility, the Plan became a fiduciary fund of the Authority. On July 1, 2004, governance reverted back to the Plan's Board, yet administrative responsibilities remained with the Authority. On July 1, 2005, governance of the Plan permanently transferred to the Authority.

The Plan was established to provide families with an opportunity to save for future postsecondary education expenses. The Plan investment strategy is to earn rates of return that exceed anticipated tuition inflation rates so that the Plan is able to meet its obligation to pay benefits at future tuition rates. The Plan typically offers enrollment periods on at least an annual basis for purchasers to buy prepaid tuition contracts. The Plan offers certain federal and state tax advantages to purchasers.

The Plan is designed as an investment option for Kentucky families that will earn a return that will keep pace with tuition inflation in Kentucky. Participants buy annual tuition units at current tuition levels and receive benefits equal to tuition rates in place at the time that the student attends a qualified postsecondary education institution. The Plan offers three tuition plans – the Value Plan, the Standard Plan and the Premium Plan. In the Value Plan, participants buy tuition units and receive benefits indexed to the tuition rate of the Kentucky Community and Technical College System. The Standard Plan offers tuition units and benefits indexed to the tuition rate of Kentucky's most expensive public university. The Premium Plan offers tuition units at the current average tuition cost of Kentucky's private colleges and universities and guarantees a return on a participant's investment equal to the tuition inflation rate for the University of Kentucky.

Participants may elect to spread payments to the Plan over three, five or seven years, or until the anticipated year of the student's enrollment in a qualified postsecondary education institution.

Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note A--Description of Business--Continued

Participants may use Plan benefits for eligible educational expenses at any eligible public or private vocational school, college or university in the United States. If a beneficiary attends an eligible educational institution with tuition rates in excess of Plan benefits, the Plan will not be responsible for the difference. If a beneficiary attends an eligible educational institution with tuition rates less than Plan benefits, participants may use the difference for other qualified educational expenses such as room, board, books, and supplies.

Participants may withdraw from the Plan at any time for any reason. Terminating participants are refunded any contract payments made less benefits received, administrative expenses and cancellation fees. Participants who withdraw after July 1 of the beneficiary's college entrance year receive the tuition payout value of the contract less benefits received, administrative expenses and cancellation fees. Non-qualified withdrawals are subject to a 10% penalty in accordance with Section 529 of the Internal Revenue Code ("IRC") except in cases where the withdrawal is: (i) made on account of the death or disability of the student, (ii) made on account of a scholarship received by a student, or (iii) a non-taxable transfer to another account or to another IRC Section 529 program for a different student who is a family member of the original student.

The Authority administers the Trust, the Plan, College Access Program, Kentucky Tuition Grants, Teacher Scholarships, Osteopathic Medicine Scholarship Program, Mary Jo Young Scholarships, Robert C. Byrd Honors Scholarships, Kentucky Educational Excellence Scholarships, and Work Study, and manages the funds for the Kentucky National Guard Tuition Award Program. The 2000 General Assembly enacted legislation giving the Authority administrative responsibility for a certain portion of the new Early Childhood Development Scholarship Program. The Authority's grant, scholarship and work-study programs are funded by appropriations from the Kentucky General Assembly, grants from the USDE, and allocation of revenues from the Kentucky Lottery Corporation, Coal Severance Tax, Tobacco Settlement funds, and transfers from the AOF.

Note B--Summary of Significant Accounting Policies

Basis of Presentation--The Authority reports its financial information in accordance with the Government Accounting Standard Board ("GASB") Statement No. 34, *Basic Financial Statements and Management's Discussion Analysis - for State and Local Governments* as amended by GASB No. 37 and modified by GASB No. 38, *Certain Financial Statement Disclosures*, (collectively "GASB 34").

The Authority's basic financial statements are prepared in accordance with GASB 34 and are comprised of three components: 1) government-wide financial statements; 2) fund financial statements; and 3) notes to the financial statements.

Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note B--Summary of Significant Accounting Policies--Continued

The government-wide financial statements are comprised of a statement of net assets and a statement of activities. Prepared using the economic resources measurement focus and the accrual basis of accounting, these statements reflect all of the assets, liabilities, revenues, expenses, gains and losses of the combined Authority's governmental and business-type activities. The Authority's government activities reflect the activities of administering the various student grant, scholarship, loan programs, and work-study programs for the Commonwealth of Kentucky and the USDE. The Authority's business-type activities include the activities of administering loan guarantee, default collection, lending and related activities, and other lender services.

The government-wide financial statements do not reflect fiduciary activities whose resources are not available to finance the Authority's programs. Fiduciary activities include private-purpose trust and agency funds administered by the Authority pursuant to the FFELP and the Trust.

The Authority's fund financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America applicable to state government entities, which provides that accounting systems be organized by funds to account for specific activities consistent with legal and operating requirements. The Authority's governmental funds include the activities of administering grant, scholarship and loan programs, and work-study programs for the Commonwealth of Kentucky and USDE. The Authority's loan guarantee, default collection and other lender assistance services are presented as proprietary funds. Proprietary funds also include an internal service fund which is used to report activities provided to the Authority's other business-type activities. The Authority follows all applicable Accounting Principles Board Opinions issued on or before November 30, 1989 for its proprietary funds, unless those pronouncements conflict with or contradict GASB pronouncements.

The Authority's fiduciary funds include the FSLRF, which is used to account for assets, liabilities, revenues, and expenses that the Authority administers for the federal government as noted above.

The Authority's fiduciary funds include agency funds, which are held in purely a custodial capacity. Agency Funds include proceeds received from student loan lenders and later remitted to a college or university to pay for tuition assistance for a respective student. The fiduciary funds also include assets, liabilities, additions, and deductions to net assets related to the Trust and the Plan. Assets of the Trust are held by the Authority on behalf of program participants. Assets of the Plan are held by the Authority to offset future tuition obligations of participants.

The Authority uses the accrual basis of accounting.

Investments--Investments for all funds except the Plan consist primarily of securities of the federal government or its agencies, commercial paper and collateralized mortgage obligations and mutual funds, and are stated at fair market value. Fair market value is determined by using quoted market prices as of the last day of the fiscal year.

Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note B--Summary of Significant Accounting Policies--Continued

The Plan invests in certain debt and equity instruments which are reported at fair value. Fair values are determined using quoted market values as of the last day of the reporting period where available. Securities for which quoted market prices are not available are valued using estimates based on similar securities.

To achieve an actuarially determined target rate of gross return of 7.76%, the Plan's investments shall be held in approximately the following composition.

| | |
|---------------------------|-------------------|
| Large cap U.S. stocks | 45% |
| Small/Midcap U.S. stocks | 10% |
| Non-U.S. stocks | <u>5%</u> |
| Total Equity | <u>60%</u> |
| | |
| Inflation indexed bonds | 25% |
| Corporate bonds | <u>15%</u> |
| Total Fixed Income | <u>40%</u> |

To decrease overall investment risk, the following restrictions apply to the Plan's investments:

- i. No more than 5% of the total amount of the equity portion of the investment account in the securities of any one issuer;
- ii. No more than 25% of the total amount of the equity portion of the investment account in any one industry, as defined by Standard & Poors;
- iii. For portfolios invested in major-market countries, no more than 25% of the total amount of the equity portion of the investment account in any one country, with the exception of those countries whose weighting in the Europe, Australia, and Far East ("EAFE") index is greater than 25%, where a maximum weight of the current country weight in the EAFE benchmark plus 10% is permitted;
- iv. For portfolios invested in emerging markets, no more than 20% of the equity portion of the investment account shall be invested in one country;
- v. A minimum of eight countries shall be represented in each investment account; and
- vi. No more than 10% of the total amount of the fixed-income portion of the investment account shall be committed to the securities of any one issue at the time of purchase, with the exception of securities issued or guaranteed by the full faith and credit of the United States of America or AAA-rated securities issued by government agencies as to which there is no limit.

Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note B--Summary of Significant Accounting Policies--Continued

Teacher and Osteopathic Medicine Scholarship Loans and Advances--Teacher scholarship advances to students may be repaid via eligible service credits granted for specified teaching in primary or secondary schools. The disbursements are recorded as advances and charged to program benefits over the period that the teaching service is performed. If the teaching requirements are not satisfied, the advances are converted to loans which are repayable with interest.

Osteopathic medicine scholarship advances to students may be repaid via eligible service credits granted for working as a doctor in Kentucky. The expenditures are recorded as advances and charged to program benefits over the period that the medical services are provided. If the medical requirements are not satisfied, the advances are converted to loans which are repayable with interest.

Property and Equipment--Property and equipment is stated at cost less accumulated depreciation. Property and equipment is depreciated beginning when the asset is placed in service and continues over the estimated useful life of the respective asset using the straight-line method.

Defaulted Student Loans--All collections on defaulted loans are recorded as income when received. The portion of collections due to the federal government is treated as an expense. Federal defaulted loans outstanding are accounted for by the Authority but are not presented in the accompanying financial statements.

Statement of Cash Flows--In the statement of cash flows, the Authority considers cash and cash equivalents to include highly liquid investments, which mature within one month of purchase.

Use of Estimates--The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues, expenses, and expenditures during the reporting period. Actual results could differ from those estimates.

Program Revenues--Program revenues are reported in two categories including (1) charges for services and (2) program-specific operating grants and contributions. Charge for services include revenues received in the form of fees and charges for the Authority loan guarantee, default collection and other lender services, and interest income from the corporate lending activities. Program-specific operating grants and contributions include revenues from mandatory and voluntary nonexchange transactions with other governments and organizations that are restricted for use in a particular program. Program-specific operating grants and contributions include the interest earned on scholarship loans.

Contribution Receivable--As discussed in Note A, participants in the Plan may elect to make payments on executed tuition contracts over a specific period. Contributions receivable are recorded at their net realizable value in the period in which a tuition contract is purchased. A finance charge of 7.25% per year is charged to participants based on outstanding balances.

Continued

Notes to Financial Statements--Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note B--Summary of Significant Accounting Policies--Continued

Tuition Benefits Payable--Tuition benefits payable are reported at the actuarial net present value of estimated future benefits to be paid on behalf of participants of the Plan. The reported amount reflects actuarial assumptions, including anticipated tuition and fee increases, expected investment earnings and terminations.

Indirect Cost--Indirect costs are allocated to functions/programs utilizing a full cost allocation approach with the objective of allocating all expenses to the Authority's various functions and programs.

Operating Revenues and Expenses--The Authority follows a policy of defining proprietary funds as operating and non-operating revenues and expenses utilizing the guidance set forth in GASB Statement No. 9.

Risk Management--The Authority is exposed to various risks of loss related to property loss, torts, errors and omissions, and employee injuries. Coverage for these various risks of loss are obtained through the Authority's participation in the Commonwealth of Kentucky's Risk Management Fund and State Sponsored Group Insurance Fund.

Note C--Cash and Investments

In March 2003, the GASB issued Statement No. 40 "Deposits and Investment Risk Disclosures," which is effective for periods beginning after June 15, 2004. Risk disclosures in previous financial statements (under the provisions of GASB Statement No. 3) focused only on custodial credit risk. GASB Statement No. 40 not only addresses custodial credit risk but other common areas of investment risk as well, including interest rate risk, credit risk and concentration of credit risk.

Continued

Notes to Financial Statements--Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note C--Cash and Investments--Continued

Custodial Credit Risk and Interest Rate Risk--Custodial credit risk is the risk that in the event of a bank failure, the Authority's deposits may not be returned to it. The Authority's investment policy does not contain a requirement for collateralization of cash and investments nor does it require investments to be maintained in the Authority's name. Furthermore, the Authority's investment policy does not limit maturities of its investments. As of June 30, 2006, the Authority's proprietary fund, governmental fund and fiduciary funds maintained custodial credit risk for cash on deposit as follows:

| | Governmental Fund Bank Balance | Proprietary Fund Bank Balance | Fiduciary Fund Bank Balance |
|---|---|--|--|
| Insured (FDIC) | | \$ 200,000 | \$ 200,000 |
| Uninsured: | | | |
| Collateralized by securities held by pledging financial institution | | 3,804,404 | 3,304,926 |
| Cash deposited with Kentucky State Treasurer | \$ 2,590,833 | 1,871,248 | 157,285 |
| | <u>\$ 2,590,833</u> | <u>\$ 5,875,652</u> | <u>\$ 3,662,211</u> |

As of June 30, 2006, all proprietary fund investments were registered in the Authority's name and maintained by an external trustee. The investment balances as of June 30, 2006 are summarized as follows:

| | Fair Value | Weighted Average Maturity |
|---|----------------------|--|
| Corporate bonds | \$ 5,173,649 | 5.65 years |
| U.S. Treasury and government agency securities | 1,853,975 | 2.46 years |
| Collateralized mortgage obligations | 3,076,996 | 19.23 years |
| Money market securities | 7,582,397 | |
| | <u>\$ 17,687,017</u> | |

Continued

Notes to Financial Statements--Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note C--Cash and Investments--Continued

As of June 30, 2006, the investment portfolio maintained by the Trust (\$77,620,957) was comprised entirely of TIAA mutual funds. The investment portfolio maintained by the FSLRF was comprised of the following:

| | <u>Fair Value</u> | <u>Weighted Average Maturity</u> |
|-------------------------------------|---------------------|--|
| Collateralized mortgage obligations | \$ 6,227 | 3.23 years |
| Money market securities | <u>6,695,976</u> | |
| | <u>\$ 6,702,203</u> | |

The investment balances as of June 30, 2006 for the Plan are summarized as follows:

| | <u>Fair Value</u> | <u>Weighted Average Maturity</u> |
|---|----------------------|--|
| Corporate bonds | \$15,375,045 | 4.82 years |
| U.S. Treasury and government agency securities | 25,838,956 | 11.85 years |
| Corporate stock | 71,328,777 | |
| Money market securities | <u>5,256,704</u> | |
| | <u>\$117,799,482</u> | |

Investments are made based upon prevailing market conditions at the time of the transaction with the intent to hold the instrument until maturity. If the yield of the portfolio can be improved upon sale of an investment prior to its maturity, with the reinvestment of proceeds, then this provision is also allowed.

Concentration of Credit Risk--The Authority does not maintain investments in any one issuer that represents 5% or more of the total investment base, excluding investments issued or explicitly guaranteed by the U.S. government and investments in money market securities.

Credit Risks--The Authority maintains an investment policy that limits the credit risk for securities to investment grade and above by one of the nationally recognized credit rating agencies. As of June 30, 2006, the Authority's proprietary fund maintained securities issued by U.S. Treasury and governmental agencies with a Standard & Poor's rating of AAA.

Continued

Notes to Financial Statements--Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note C--Cash and Investments--Continued

The following table summarizes the Standard & Poor's rating for all corporate bonds held by the Authority's propriety fund as of June 30, 2006.

| <u>Rating</u> | <u>Fair Value</u> |
|---------------|--------------------|
| AAA | \$3,577,696 |
| AA | 258,635 |
| A | 297,015 |
| BAA | 146,364 |
| BBB | 25,328 |
| BBB- | 868,611 |
| | <u>\$5,173,649</u> |

The investment policy for the FSLRF limits the investment type to government backed securities. As of June 30, 2006, the U.S. backed collateralized mortgage obligations in the FSLRF contain a Standard and Poor's rating of AAA.

The Plan maintains an investment policy that limits the credit risk for fixed income securities and short-term commercial paper. The Plan invests in AAA-rated securities issued by governmental agencies and long-term commercial paper with an investment grade rating, as long as the overall fixed income portfolio maintains a minimum rating of A by Moody's or Standard & Poor's. The Plan may only invest in short-term commercial paper, maturing within 9 months, with a minimum rating of A-1 by Standard & Poor's or Prime 1 by Moody's.

Continued

Notes to Financial Statements--Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note C--Cash and Investments--Continued

As of June 30, 2006, the Plan maintained securities issued by U.S. Treasury and governmental agencies with a Standard & Poor's rating of AAA. The following table summarizes the Standard & Poor's rating for all corporate bonds held by the Plan as of June 30, 2006.

| <u>Rating</u> | <u>Fair Value</u> |
|---------------|---------------------|
| AAA | \$2,228,541 |
| AA | \$448,524 |
| AA- | 2,561,313 |
| A+ | 3,313,473 |
| A | 3,375,347 |
| A- | 1,471,728 |
| BBB+ | 992,331 |
| BBB | 736,083 |
| BBB- | 195,795 |
| B+ | 51,910 |
| | <u>\$15,375,045</u> |

Note D--Property and Equipment

A summary of property and equipment follows:

| | <u>July 1, 2005</u> | <u>Additions</u> | <u>Deletions</u> | <u>June 30, 2006</u> |
|--------------------------|----------------------|---------------------|------------------|----------------------|
| Proprietary fund: | | | | |
| Furniture and equipment | \$ 5,950,230 | \$ 38,739 | \$ (100,751) | \$ 5,888,218 |
| Building | 11,993,435 | | | 11,993,435 |
| Accumulated depreciation | <u>(6,340,506)</u> | <u>(1,028,046)</u> | <u>100,751</u> | <u>(7,267,801)</u> |
| | <u>\$ 11,603,159</u> | <u>\$ (989,307)</u> | <u>\$ -</u> | <u>\$ 10,613,852</u> |
| Fiduciary fund: | | | | |
| Furniture and equipment | \$ 623,803 | | | \$ 623,803 |
| Accumulated depreciation | <u>(621,286)</u> | <u>\$ (2,517)</u> | | <u>(623,803)</u> |
| | <u>\$ 2,517</u> | <u>\$ (2,517)</u> | <u>\$ -</u> | <u>\$ -</u> |

Continued

Notes to Financial Statements--Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note D--Property and Equipment--Continued

Depreciation expense totaled \$1,030,563 for the year ended June 30, 2006, of which \$682,142 was allocated to business-type activities, \$11,015 was allocated to the fiduciary activities and \$337,406 was allocated to the governmental activities. Depreciation expense was allocated to the business-type activities functions as follows:

| | |
|---------------------------|-------------------|
| Loan guarantee operations | \$ 319,486 |
| Default collections | 218,093 |
| Lender assistance | 131,246 |
| Other | <u>13,317</u> |
| | <u>\$ 682,142</u> |

Note E--Federal Family Education Loan Programs

Pursuant to the FFELP, the Authority insures eligible student loans for losses incurred from the default, death, disability or bankruptcy of the borrower, and also insures for other losses such as school closures and false certifications. As of June 30, 2006, the outstanding balance of aggregate insured student loans was approximately \$3.6 billion.

Loans insured by the Authority are reinsured under the FFELP by the federal government. Death, disability, bankruptcy, lender of last resort and closed school claims are reinsured at 100%. Default claims are subject to the Authority's default claims rate (reimbursed default claims for the federal fiscal year divided by the original principal amount of loans in repayment at the beginning of the fiscal year).

Reimbursement for default claims is determined according to the following schedule:

| <u>Through September 30, 1993</u> | <u>September 30, 1998</u> | <u>and After</u> |
|--|---|---|
| 100% | 98% | 95% |
| 100% of claims up to 5%, plus 90% of claims over 5% up to 9% | 98% of claims up to 5%, plus 88% of claims over 5% up to 9% | 90% of claims to 5%, plus 85% of claims over 5% up to 9% |
| 100% of claims up to 5%, plus 90% of claims over 5% up to 9%, plus 80% of claims over 9% | 98% of claims to 5%, plus 88% of claims over 5% up to 9%, plus 78% of claims over 9% | 98% of claims to 5%, plus 85% of claims over 5% up to 9%, plus 75% of claims over 9% |

Continued

Notes to Financial Statements--Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note E--Federal Family Education Loan Programs--Continued

The Authority is entitled to charge certain fees associated with its reinsurance activities. A summary of those fees are as follows:

Rehabilitated and Consolidation Loan--The Authority is entitled to retain 18.5% of principal and interest for rehabilitated loans, plus 18.5% of collection costs. For Consolidation loans, the Authority is entitled to 18.5% collection costs.

Recoveries Payable to Federal Government--The Authority is entitled to retain 24% of collections received for defaulted loans for which federal reinsurance has been received. This amount is recorded as an addition when received. After September 30, 2003, the retention rate decreased to 23% as required by the 1998 Amendments.

Account Maintenance Fees ("AMF")--The 1998 Amendments established an account maintenance fee based on .12% of the original principal amount of outstanding loans. AMF is paid to the Authority on a quarterly basis by the federal government. This fee is recognized as revenue and recorded in the AOF. In fiscal year 2001, the AMF was reduced to .10% of the original principal amount of outstanding loans.

Loan Processing and Issuance Fees ("LPIF")--The 1998 Amendments established a loan processing and issuance fee based on the net guarantee amount, less cancellations, multiplied by .65%. LPIF is paid to the Authority on a quarterly basis by the federal government. This fee is recognized as revenue and recorded in the AOF. Effective on September 30, 2003, LPIF was reduced from .65% to .40% of net guarantees, less cancellations.

Default Aversion Fees ("DAF")--Default aversion fees were established under the 1998 Amendments. The Authority receives DAF for its aversion activities on delinquent loans at the time lenders request default aversion activities. DAF's are equal to 1% of principal and interest on the loan at the time the Authority receives a request from a lender for preclaim assistance. DAF is paid monthly from the FSLRF to the AOF and is recognized as a deduction in the FSLRF and as revenue in the AOF.

Note F--Capital Lease Payable

On June 22, 2000, the Commonwealth of Kentucky, State Property and Building Commission (the "Commission") issued \$8,825,000 in bonds on behalf of the Authority. The proceeds of the bonds are used to house the Authority's operations located in Frankfort, Kentucky. On October 8, 2003, the Commission issued additional bonds on behalf of the Authority as a partial refunding of the original bonds.

Continued

Notes to Financial Statements--Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note F--Capital Lease Payable--Continued

The original bonds bear interest at a fixed rate, which varies from 5.00% to 5.30% and have a final maturity date of May 1, 2020. The new bonds bear interest at a fixed rate, which varies from 2.0% to 5.25% and have a maturity date of May 2020. The bonds are special and limited obligations of the Commission. The bonds do not constitute a debt, liability or obligation of the Commonwealth of Kentucky or a pledge of the full faith and credit or taxing power of the Commonwealth of Kentucky, but are payable solely from amounts derived from the biennially renewable lease agreement with the Authority as described below. The bondholders have no security interest in any properties constituting the project or any amounts derived there from. The scheduled payments of principal and interest on the bonds are guaranteed under an insurance policy.

In connection with the issuance of the bonds, the Authority entered into a financing/lease agreement with the Commission whereby the Authority agreed to lease the newly constructed building. The lease was for an initial two-year term ending June 30, 2002, with the right to renew for nine additional two-year renewal periods.

The Authority can cancel the lease on the last business day in May immediately preceding the beginning of any renewal term. The lease payments are equal to the debt service required by the bond indenture. In connection with the agreements, the Commonwealth of Kentucky General Assembly appropriated sufficient spending authorization to the Authority to pay the lease payments required for the initial two-year term. There can be no assurance to make rent payments past the two-year renewal lease period. The Authority did renew the lease for the biennium ending June 30, 2008.

The total estimated cost of the building is \$11,993,435 with approximately \$3.2 million of the building costs paid from the Authority's operating reserves. Net interest incurred from the issuance date of the tax exempt debt to the date that the building was available for use by the Authority has been capitalized as part of the building cost.

A summary of the activity for the capital lease for the year ended June 30, 2006 is as follows:

| | July 1 2005 | Additions | Payments | June 30 2006 |
|-----------------------|------------------------|------------------|-------------------|-------------------------|
| Capital Lease Payable | <u>\$ 7,735,000</u> | <u>\$ -</u> | <u>\$ 365,000</u> | <u>\$ 7,370,000</u> |

Continued

Notes to Financial Statements--Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note F--Capital Lease Payable--Continued

Debt service requirements for the next five fiscal years and thereafter are as follows:

| Year Ending June 30, | Principal | Interest |
|-----------------------------------|---------------------|---------------------|
| 2007 | \$ 380,000 | \$ 363,559 |
| 2008 | 400,000 | 344,569 |
| 2009 | 420,000 | 324,259 |
| 2010 | 440,000 | 302,659 |
| 2011 | 465,000 | 279,799 |
| Five Years Ending June 30, | | |
| 2012 - 2016 | 2,635,000 | 1,085,850 |
| 2017 - 2020 | 2,630,000 | 348,218 |
| | <u>\$ 7,370,000</u> | <u>\$ 3,048,913</u> |

Note G--Retirement Plans

The Commonwealth of Kentucky provides retirement benefits to all of the Authority's eligible full-time employees through the Kentucky Employees Retirement System ("KERS"). KERS is a cost-sharing multiple employer defined benefit plan, sponsored by the Commonwealth of Kentucky, which provides retirement, disability, and death benefits. The Authority contributed 5.89% in 2006, 2005 and 2004, and the employees contribute 5% of their gross wages to the plan. Such rates were intended to provide for normal costs on a current basis, plus an amount equal to the amortization of past service costs over 30 years, using the level percentage of payroll method. These rates are determined by the Board of Trustees of the Kentucky Retirement System each biennium. The Authority's rate for the year ending June 30, 2007 will be 7.75%. The payroll of employees covered by the retirement plan was approximately \$4,778,913 (which approximates total payroll) for the year ended June 30, 2006. KERS participants have a fully vested interest after the completion of sixty months of service, twelve months of which are current service.

The KERS contribution requirement for the year ended June 30, 2006 was \$520,424, which consisted of \$281,478 in Authority contributions and \$238,946 from employees. The Authority's contributions to KERS were \$335,508 and \$380,374 for the years ended June 30, 2005 and 2004, respectively. Although separate measurements of assets and pension benefit obligation are not available for individual employers, the annual KERS financial report (which is a matter of public record) contains this information for KERS as a whole. It may be obtained from the KERS by writing to them at 1260 Louisville Road, Perimeter Park West, Frankfort, Kentucky 40601.

Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note G--Retirement Plans--Continued

Until June 30, 1994, Teachers Insurance and Annuity Association ("TIAA") was offered to eligible employees. TIAA was terminated as of June 30, 1994 and all TIAA participants became covered by KERS effective July 1, 1994. In order to provide coverage equivalent with KERS participants to the Authority's employees who were former TIAA participants regarding retirees' health insurance premiums, the Authority established an allowance for retirees' insurance based on management's projected estimate of future requirements. The portion of retirees' premiums paid by KERS is based on years of service under KERS; the allowance provides for the Authority to fund a portion of premiums, which will result in the same coverage for the 5 employees covered. Plan assets and the accrued liability for the postretirement healthcare plan totaled \$325,523 at June 30, 2006.

Note H--Tuition Benefit Payable

The following assumptions developed by management were used in the actuarial valuation as of June 30, 2006. These assumptions are based on historical data for both state and national trends.

Investment Rates--The investment yield assumption is based on estimates of the yields that will be available on the investment portfolio and cash and cash equivalents. Since inception, the gross investment yield assumption has been 7.76% per annum.

Investment Expenses--The investment expense assumption is based on a sliding scale of costs related to total assets. The investment expense was projected as .49% of the first \$25 million, .28% of the next \$25 million and .21 % of assets in excess of \$50 million. The investment expense is now assumed to be 35 basis points on all invested assets.

Tuition Increases--Tuition increases are based on the known increases for the next academic year and best estimates of future tuition increases for Kentucky's public vocational schools, two-year colleges, and universities. The historical tuition increases are as follows:

- Upon inception of the Plan, in Fiscal Year 2002, the assumption for tuition increases was 6.5% for all future academic years.
- As of June 30, 2003, known tuition increases for the 2003-2004 academic year were 23.4% for the Value Plan and 14.4% for the Standard Plan and the Premium Plan. The assumption for tuition increases was adjusted to 7.5% for the next five academic years and 6.5% for all academic years thereafter.
- As of June 30, 2004, known tuition increases for the 2004-2005 academic year were 24.2% for the Value Plan and 16.98% for the Standard Plan and the Premium Plan. The tuition increase assumption was adjusted to 7.5% annually through the academic year ending June 30, 2011, and increased from 6.5% to 7.00% for each academic year thereafter.

Continued

Notes to Financial Statements--Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note H--Tuition Benefit Payable--Continued

- As of June 30, 2005, known tuition increases for the 2005-2006 academic year were 6.5% for the Value Plan and 12.5% for the Standard Plan and the Premium Plan. The tuition increase assumption was adjusted to 7.5% through year ending June 30, 2012, 7.25% annually through year ending June 30, 2014, and 7.0% annually thereafter.
- As of June 30, 2006, the known tuition increases for the 2006-2007 academic year were 11.2% for the Value Plan and 12% for the Standard Plan and the Premium Plan. The tuition increase assumption was adjusted to 11% for the 2007-2008 academic year, 10% for 2008-2009 academic year, and 7% for each year thereafter.

For the period from inception to June 30, 2006, the annualized tuition increase for the highest-priced Kentucky public university, as applicable to the tuition benefits payout rate of the KAPT Standard Plan, which represents 90% of KAPT enrollments, has been 11%. For the Kentucky Community and Technical College System (KCTCS), as applicable to the tuition benefits payout rate of the Value Plan, the average annualized tuition increase from inception to June 30, 2006, has been 21.6%. For the University of Kentucky, as applicable to the tuition benefits payout rate of the KAPT Premium Plan, the average annualized tuition increase from inception to June 30, 2006 has been 12.6%.

Payment of Tuition and Mandatory Fees--Payments of tuition and mandatory fees are assumed to be 128 credit hours of utilization and payments occur twice annually.

Note I--Restricted Net Assets

Federal Student Loan Reserve Fund--Net assets are restricted for use on certain FFELP activities, primarily the payments of claims.

Agency Operating Fund--Net assets are restricted for use on certain FFELP activities and other student aid activities.

Student Aid Funds--The Student Aid net assets are restricted for use in the Student Aid Programs.

Notes to Financial Statements--Continued

Kentucky Higher Education Assistance Authority

June 30, 2006

Note J--Commitments and Contingencies

The FSLRF, a fiduciary fund maintained on behalf of the USDE, is contingently liable for loans made by financial institutions that qualify for guaranty. The default ratio for loans guaranteed by the Authority is below 5% for the federal fiscal year ended September 30, 2004. As a result, the federal government's reinsurance rate for defaults for that period is 100% for loans made prior to October 1, 1993, and 98% for loans made on or after October 1993 to September 30, 1998. In the event of future adverse default experience, the Authority could be liable for up to 25% of defaulted loans. At the beginning of each fiscal year, the Authority's reinsurance rate returns to 98%; management does not expect that all guaranteed loans could default in one year.

For loans made on or after October 1, 1998, the reinsurance rate will be 95%. In the event of future adverse default experience, the Authority could be liable for up to 25% of such defaulted loans.

While management believes the FSLRF's expected maximum contingent liability is less than 25% of outstanding guaranteed loans, the maximum contingent liability at June 30, 2006 is calculated as follows:

| | |
|---|-----------------------|
| Amount of guaranteed student loans outstanding at lenders | \$ 3,619,085,511 |
| Less minimum federal government share - 75% | <u>2,714,314,133</u> |
| | <u>\$ 904,771,378</u> |

Note K--Related Party Transactions

The Authority has a shared services agreement with the Corporation. The Corporation has a separate shared services agreement with the Authority. Under these agreements, the Authority and the Corporation perform certain services for each other. The agreements cover such areas as information processing services and technology, collection services, internal audit, executive management and professional support services, clerical administrative and technical support services, creative services, and cooperative procurement. During the year ended June 30, 2006, the Corporation provided net services to the Authority valued at \$4,504,000.

The Authority also maintains a loan origination and disbursement services agreement with the Corporation. During the year ended June 30, 2006, the Authority received \$767,753 from the Corporation for loan origination and disbursement services. As of June 30, 2006, the Corporation owed the Authority an additional \$208,307.

The Corporation reimburses the Authority for all direct postage charges related to the Corporation. The Authority received \$1,633,436 from the Corporation during the year ended June 30, 2006 for postage reimbursement. As of June 30, 2006, the Corporation owed the Authority an additional \$57,079.